



International Comparative Jurisprudence



FIDUCIARY DUTIES IN THE PRIVATE EQUITY AND VENTURE CAPITAL WORLD

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Abstract. In many countries, private equity (PE) and venture capital (VC) are a growing part of the economy, and concerns have surfaced over how PE/VC money is managed and spent. Investors want to ensure that their investments are in good hands, while government bodies want to prevent PE/VC funds from being abused as vehicles for scams and fraud.

PE/VC fund managers are often bound by fiduciary duties. In certain countries, however, no fiduciary duty is imposed, and in other countries such duties may be contractually eliminated. In such instances where managers operate without owing fiduciary duties, this raises questions about how best to protect vulnerable investors.

This paper contributes to the literature on PE/VC industries and their regulation. It demystifies and describes the operation and structure of partnership-type PE/VC funds, which can be a black box to less sophisticated investors. With the basic structure outlined, the paper then highlights the critical role of specific fiduciary duties, as well as the various potential problems arising from a lack of such duties. Finally, given the increasing prevalence of PE/VC funds particularly in developing markets and the corresponding need for regulation, the paper also analyses potential solutions and safeguards that can be implemented to improve regulatory regimes.

Keywords: private equity, venture capital, fiduciary duties, investor protection, market regulation

Introduction

An oft-heard idiom among entrepreneurs and businessmen is that “it takes money to make money” (McGraw-Hill Dictionary of American Idioms and Phrasal Verbs, 2002). Nowhere does this adage hold more weight than in the spheres of private equity (PE) and venture capital (VC). Wealthy entities and individuals, eager to profit from their significant financial resources, often turn to PE/VC funds and invest vast sums of their money in the hope of earning significant returns. It is not unusual to see hundreds of millions being invested by entities with significant financial means, such as public pension, sovereign wealth or university endowment funds (Carey & Morris, 2010). In many states, PE is a growing part of the economy. For instance, in the United Kingdom (UK) alone, nearly 10% of the workforce is employed in PE-owned companies, and an increasing number of large companies are being taken over by PE funds (House of Commons Treasury Committee, 2007). Worldwide, 2015 saw an all-time high of 2209 PE/VC funds seeking more than US\$800 billion in funding (Drean, 2015).

With so much money circulating in the PE/VC market, it is unsurprising that concerns have surfaced over how it is managed and spent. Some of these concerns are felt chiefly by the investors, who naturally want to ensure that their investments are in good hands. However, government bodies also have an interest in regulating the PE/VC market to ensure that funds in this area are not abused as vehicles for scams and fraud (Stevenson & Goldstein, 2016). As such, the managers of PE/VC funds – those in a position to make day-to-day decisions about the management of the money and its expenditure – are often bound by fiduciary duties (Harris, 2010). These duties, usually imposed either statutorily or in common law (Morse, 2006), ensure that fund managers uphold a certain standard of performance and loyalty in carrying out their work.

However, this is not the case in every jurisdiction. In some places, such as in the People's Republic of China, as well as in Taiwan (officially the Republic of China), no fiduciary duty is imposed on fund managers in partnership-type PE/VC funds (Lin, 2013). And in the US state of Delaware, which is frequently recommended as the best jurisdiction in which to form a PE/VC fund (Black, 2007), the situation is even more complicated. Until recently, it was hotly debated whether fund managers in partnership-type PE/VC funds would owe fiduciary duties by default, with conflicting judgements for (*Kelly v. Blum, et al* (2010); *Twin Bridges Limited Partnership, et al. v. Ford B. Draper, Jr.* (2007)) and against this idea (*Fisk Ventures, LLC v. Segal, et al.* (2008); *R&R Capital, LLC, et al. v. Buck & Doe Run Valley Farms, LLC, et al.* (2008)). Although the debate has been settled at least in part (Eisenhofer & Moyna, 2015), it is also generally accepted that Delaware law permits the elimination of these duties through contractual agreement (Winnifred, 2013).

With some PE/VC fund managers still working outside the boundaries of fiduciary obligations, this naturally raises questions about how best to protect investors in such funds. These take on particular importance in the wake of the 2007 financial crisis, as such events inevitably precipitate legislative and regulatory backlash (Ferran, 2011). In Part 1, this paper will examine the operation and basic structure of partnership-type PE/VC funds to provide a better understanding of the significance of fiduciary duties. Part 2 will study the function and particular significance of fiduciary duties in PE/VC funds, and Part 3 will delve into the various potential problems arising from a lack of such fiduciary duties. With the issues clearly highlighted, Part 4 will analyse the possible solutions that can be implemented, as well as their respective shortcomings. Finally, the paper will conclude with some broad, yet fundamental observations on the protection of investors in partnership-type PE/VC funds.

1. The Partnership-Type Private Equity/Venture Capital Fund

To better understand how investor interests can be protected, it is important to first understand how partnership-type PE/VC funds are structured, and how fiduciary duties fit into this structure. Although fiduciary duties have always formed a core part of business law (Frankel, 2011), they take on a place of renewed importance in partnership-type PE/VC funds because of the nature of such partnerships.

PE funds are driven by a desire to increase the value of various target companies over and above the purchase price (Payne, 2011). Fund managers raise capital and invest in various companies in exchange for significant shareholdings. These companies are then known as portfolio companies of the PE fund. In fact, many of today's massive public companies, such as Apple and Google, relied upon seed money from PE funds early on (Harris, 2010). Such investments would probably have been akin to the Holy Grail of PE, with many of the funds that made them realising outsized returns for their investors and managers (Harris, 2010). In 1999 alone, for instance, the average reported return on investment was an incredible 163% (Rosenberg, 2002). With an injection of resources, it is hoped that a portfolio company appreciates in value so that its shares can then be sold for a profit. One popular exit strategy with PE funds is for the portfolio company to do well enough that it can be listed (or relisted, for previously public companies that the PE fund had taken private) on a stock exchange. The PE fund then stands to make a tidy profit selling the company's shares during the initial public offering (IPO) (Payne, 2011). Alternatively, the appreciated shares can simply be sold to other PE funds, or the portfolio company can be liquidated (Payne, 2011).

VC funds operate similarly to PE funds, except that they invest almost exclusively in smaller, nascent companies, such as start-ups built around cutting-edge technology. Given their small size, such portfolio companies can greatly appreciate in value, but investors also expose themselves to larger risk because the prospects of such speculative companies are often uncertain and cash flow will probably be negative in the early years at least (Klausner & Litvak, 2001). VC funds are thus a high-risk, high-reward subset of PE funds. Although the target companies may be different, both types of fund share the same common desire of maximising the value of their portfolio companies.

To carry out their business, PE/VC funds generally require two key players – fund managers and investors. Together, these will often form an entity – the PE fund itself. The most popular form of entity is currently the

limited partnership (Lerner, Hardyman, & Leamon, 2008), and there are several reasons why this is the case. The main one involves the partitioning of liability among partners in a limited partnership. Partnership-type PE/VC funds consist of two types of partners – general partners (GPs) and limited partners (LPs). GPs are in charge of a fund's day-to-day running and make critical decisions pertaining to fundraising and the selection and management of portfolio companies (Harris, 2010). In exchange for enjoying a greater degree of control than LPs, GPs are also exposed to the fund's liabilities and can potentially be liable for claims that exceed the fund's assets (Harris, 2010). At the other end of the spectrum, LPs have a much more restricted role in a fund's day-to-day operations. Also known as "passive" partners, LPs have no default rights to manage the fund on a day-to-day basis, and cannot, for example, enter into contracts or act as agents on the fund's behalf (Harris, 2010). Put simply, LPs by default have little right to intervene in the operational decisions of the GPs. In exchange for relinquishing control, LPs are not usually liable beyond their capital contribution to the fund itself (Harris, 2010). This partitioning of management rights and the attendant liabilities between GPs and LPs (known colloquially as the "control rule") is enshrined in the partnership laws of several common law jurisdictions, such as in Singapore's Limited Partnerships Act 2010, or the UK's Limited Partnerships Act 1907.

Based on the structure described above, limited partnerships are often the most intuitive form of entity for PE/VC funds because they adequately suit the needs of both fund managers and investors. Investors in such funds usually take on the role of LPs and contribute to the fund by injecting capital, while benefiting from the expertise of the fund managers (Gulinello, 2006). As LPs, these investors defer management control to the fund managers, and in a worst-case scenario will not incur greater losses than the amount they were willing to risk investing in the fund in the first place. On the other hand, fund managers, which are typically specialised PE firms with investment expertise, take on the role of GPs in a fund and contribute their expertise by selecting portfolio companies and managing the investments (Harris, 2009). Fund managers benefit by gaining investment capital from the investors, and earn management fees for their work (Litvak, 2009). In many cases, fund managers also enjoy a certain percentage of any returns made on investments, known as a "carry" fee (Cosenza, 2005). However, given that these managers are in charge of decision-making for the PE/VC funds as GPs, they also bear liabilities that arise from these decisions and do not enjoy the protection offered to limited partners.

In addition, there are various other reasons for the popularity of limited partnerships among PE/VC funds. Such partnerships are set up pursuant to a partnership agreement, meaning that bespoke terms can be used to "tailor" the PE/VC fund to the needs of the investors. For instance, limited partnerships can be formed to operate for a fixed period of time. This is important because portfolio companies are relatively illiquid investments (Harris, 2010), so investors want to know beforehand exactly how long their capital will be "locked up" – with 10 years being a common duration for PE/VC funds (Cheffins & Armour, 2008). Limited partnerships are thus commonly used for PE/VC funds because they allow investors to specify the fund's lifespan.

Furthermore, in certain jurisdictions such as Singapore (Limited Partnerships Act, 2010) and the UK (Limited Partnerships Act, 1907), limited partnerships are not legal entities, so the profits generated are not subject to taxation at the entity level (Harris, 2010). Profits are only taxed at the individual level – in other words, at the level of the investors and managers. The avoidance of an additional level of taxation is significant in PE/VC funds because large amounts of money are often being transacted, so the taxes can amount to significant sums.

Finally, limited partnerships are more convenient to set up than companies and are subject to less stringent disclosure requirements during annual filings. For wealthy individuals or institutions that may wish to keep their investments discreet, forming a PE/VC fund as a limited partnership offers a level of privacy greater than if the fund were incorporated as a company (MacNeil, 2012). For all the reasons given above, although chiefly for the partitioning of management and liabilities, the limited partnership remains the ideal form of entity for PE/VC funds.

2. The Function of Fiduciary Duties

In protecting investor interest, it is crucial to understand the role of fiduciary duties in partnership-type PE/VC funds. Given the nature of limited partnerships and the division of managerial control and liabilities between GPs and LPs, as explained above, it is clear that an asymmetry of power exists in the relationship between such partners. Fund managers, as the GPs of PE/VC funds, get to effectively control the capital contributed by the LP investors. In that regard, the latter are vulnerable to the decisions made by the GPs, and are not usually in a position to interfere without the risk of forfeiting the protection of limited liability (Harris, 2010). Further, the high-risk nature of the PE/VC market only exacerbates the opportunities for GPs to take advantage of LPs (Lin, 2013). This is precisely where fiduciary duties come into the picture. In several jurisdictions, particularly common law countries (Morse, 2006), fiduciary duties are considered a fundamental principle in relations within partnerships. GPs in these jurisdictions therefore owe fiduciary duties to the limited partnership and to the other partners (Levy & Bamdas, 2003). In contrast, several civil law jurisdictions have no equivalent concept of fiduciary duties in the same context.

The exact scope of a GP's fiduciary duties is often not perfectly defined, and local courts will play a significant role in interpreting exactly what obligations the GPs must discharge to uphold their duties. Furthermore, the content of fiduciary duties as prescribed in legislation will naturally vary from jurisdiction to jurisdiction. However, at a minimum, the fiduciary duties will usually protect LPs from grossly negligent, reckless and intentionally harmful acts (Harris, 2010). These duties thus function as a preliminary line of defence, shielding LPs against the most egregious risks.

Fiduciary duties also address two main concerns with partnership-type PE/VC funds – the information asymmetry between GPs and LPs, and the issue of reducing agency costs. Given that GPs handle the day-to-day running of the fund, they often have the best knowledge of the portfolio companies' health and the potential risks that may emerge. LPs, on the other hand, are not privy to this information, because they are obliged to keep at arm's length from the decisions of the PE/VC fund. GPs are therefore in control of crucial information that LPs may lack. This forms the basis of the information asymmetry, and without fiduciary duties, managers may choose to withhold unfavourable information from the investors (Bartlett, 2006). However fiduciary duties mitigate this risk by ensuring that LPs are not intentionally kept in the dark.

Additionally, the control rule in partnership-type PE/VC funds has the undesired side effect of increasing agency costs. Ultimately, it is the LP's capital that is being invested, and GPs function somewhat in the capacity of agents for the LPs in managing the capital for them. Given that the capital being risked is that of the LP, such partners will instinctively want to monitor GPs closely to ensure they do not make decisions that diverge from the LP's own interests – and such monitoring creates additional cost (Hart, 1989). Fiduciary duties reduce agency cost by allaying some of the LP's concerns about the fund's management. LPs have less of a need to constantly monitor GPs and their decision-making if all GPs are under the blanket obligation to uphold their fiduciary duties to the fund and LPs. At the very least, LPs can be assured of recourse against GPs for breaching their fiduciary duties if some loss is incurred due to egregious behaviour by the latter.

Fundamentally, fiduciary duties therefore act to control the pitfalls inherent in the very structure of partnership-type PE/VC funds brought about by the control rule. They protect investors' interests by insulating them from the most egregious acts and, in the process, reduce information asymmetry and agency cost.

3. Absence of Fiduciary Duties

If fiduciary duties are not imposed on the GPs of PE/VC funds, several problems present themselves. Any protection of an investor's interest must take into account these problems in order to succeed. Clearly, because of the default centralised decision-making structure that applies to partnership-type PE/VC funds (Harris, 2010) and the attendant concerns about divergent interests between GPs and LPs, the issues discussed earlier pertaining to information asymmetry and agency costs will be amplified. Notwithstanding any extraneous contractual influence, GPs may no

longer be under any obligation to keep their LPs updated about the fund's health. In turn, this will increase agency costs as LPs step up monitoring efforts in a bid to keep GP decision-making in line with LP interests.

However, less-evident issues also surface in the absence of fiduciary duties. For instance, a lack of such duties is likely to spur an increase in LP activism, in which LPs seek to intervene or interfere with the GPs' management of the PE/VC fund in order to maintain a modicum of control. China presents an excellent case study in this regard. Home to the world's second-largest economy (The World Bank, 2018), China's PE/VC market is rapidly expanding, and the country is presently the second-largest in terms of gathering VC capital (Lin, 2013). Chinese law does not impose fiduciary duties on GPs in partnership-type PE/VC funds (Lin, 2013). Moreover, the majority of Chinese PE/VC investors are individuals (Lin, 2013), rather than the institutions and entities more common in other countries. As individuals, these investors are often less sophisticated and more risk-adverse than institutions (Coval, Hirshleifer, & Shumway, 2005), and coupled with the lack of fiduciary duties, this has led to increased levels of LP activism in Chinese PE/VC funds (Lin, 2013). Similarly, Taiwan, also a civil law jurisdiction without fiduciary duties for GPs, has seen elevated levels of LP activism (Lin, 2013). This indicates the correlation between fiduciary duties and LP behaviour.

Unfortunately, LP activism can often be counterproductive. Although LPs tend to have a large amount of money, it cannot be presumed that they know better than GPs how to best invest the money (Davies, 2010), since the GPs are ostensibly specialists in matters such as managing PE/VC funds, and selecting and growing portfolio companies. By interfering, LPs may put the PE/VC fund in a gridlock if their decisions conflict with those of GPs – or worse, the fund may perform suboptimally or incur losses. In any event, by interfering with the management of the PE/VC fund, LP investors will probably also sacrifice their limited liability protection afforded under limited partnership laws (Harris, 2010). By exposing themselves to increased liability, LPs will place the rest of their assets in jeopardy. This is a counterproductive consequence, especially when it cannot even be guaranteed that the LP's intervention would maximise profits in the first place over the decisions of the arguably more-knowledgeable GP fund managers.

From a top-down regulatory perspective, an absence of fiduciary duties may also increase the risk that partnership-type PE/VC funds are used as vehicles to commit fraud or scams. Opportunists may take advantage of lacunae in the law to attract ignorant investors who automatically assume that the law would come to their rescue. At the very least, the absence of such safeguards may reduce investor confidence in that jurisdiction, which in turn could lead to difficulty in raising capital for PE/VC funds from that country. It is true that such concerns may be allayed by specifically contracting for fiduciary protection, but the point nonetheless remains that regulatory oversight (or a lack of it) in the PE/VC market will ultimately affect the interests of investors, because they would have to be particularly savvy and cautious in the absence of default duties in their favour. This affects in particular less sophisticated, newly rich individual investors, which make up a large portion of the PE/VC demographic in countries such as China (Lin, 2013).

A lack of regulation in the form of fiduciary duties for GPs may also have other knock-on effects for the PE/VC market. Again, China presents an interesting case study here. Although the country has seen an explosion in fund managers in tandem with the general growth of the PE/VC market, 40% of them have less than two years of experience in the PE sector, and only 5% are veterans with at least a decade of experience (Lin, 2013). A contributing factor may be that the lack of fiduciary duties has encouraged fewer competent fund managers to come out of the woodwork and try their luck. Conversely, if a country were to impose a reasonable level of fiduciary duties on GPs in their jurisdiction, this may act as a form of "quality control" by discouraging the least competent fund managers from becoming GPs in partnership-type PE/VC funds. In this manner, the interests of investors would be better protected by encouraging a minimum standard of performance for fund managers. Without fiduciary duties, potential LPs lose that safety net.

Finally, it is worth noting that even though fiduciary duties do function to control the behaviour and decision-making of GPs, the protection afforded may not actually be very extensive. This is because the duty of care imposed can generally be discharged without much difficulty on the part of GPs. As mentioned earlier, fiduciary duties

typically only defend against grossly negligent, reckless, and intentionally harmful behaviour. Fiduciary duties therefore represent a bottom-line approach to protecting LPs. This still leaves GPs with considerable latitude in decision-making, because their actions would have to be particularly flagrant to be in violation of their fiduciary duties (Harris, 2010). It is therefore possible for GPs to make decisions that ultimately harm the PE/VC fund without being in direct violation of their fiduciary duties. And as also mentioned above, fiduciary duties are sometimes waived, or are not present at all in certain jurisdictions. The question therefore still remains: what other methods can be best employed to protect the interests of LP investors in partnership-type PE/VC funds?

4. Potential Solutions

In light of the issues discussed, several solutions can be implemented to better protect the interests of investors in partnership-type PE/VC funds in jurisdictions without fiduciary duties. This section will critically analyse some of the possibilities.

4.1. General Partner Obligations in a Partnership Agreement

The first and most natural port of call is the partnership agreement that typically underlies partnership-type PE/VC funds. In almost all cases, the parties participating in such funds will enter into a type of contract called a partnership agreement, which outlines the rights and obligations of each party. This is a foundational document that can serve to govern the relationship between GPs and LPs (Gompers & Lerner, 1996). In this way, LP investors can bind GP fund managers to specific obligations not unlike those that might be imposed under a fiduciary duty of care. For instance, LPs may impose reporting requirements on GPs with regard to the health of the fund, or place clear out-of-bound (OB) markers for GPs. Indeed, some PE commentators suggest that adequate contract design can reduce agency costs (Bartlett, 2006).

However, beyond prescribing basic obligations for GPs, LPs generally cannot craft a partnership agreement to give themselves control of the fund over a GP, because this would contravene the control rule prescribed in many countries. Further, many less-sophisticated individual investors may not comprehend the concept of fiduciary duties, especially if they originate from a civil law jurisdiction without such laws (Lin, 2013). Such investors would not be well-positioned to incorporate the pertinent duties or obligations in the partnership agreement. A simple transcribing of fiduciary duties into contract is therefore not often an adequate solution if employed on its own.

4.2. Mandatory Distribution Provisions

A potential solution is for partnership agreements to incorporate mandatory distribution provisions for profits gained from capital invested. Such provisions can deter opportunistic GP fund managers who may seek to reinvest the profits instead of distributing them to investors (Gilson, 2003). Opportunistic managers may wish to reinvest instead of distributing profits because they can then continue to earn management fees on the next investment (Gilson, 2003). This is particularly likely if managers do not stand to earn significant carry fees in distributing the profits to investors anyway. Reinvestment can also reduce the fund manager's need to raise further capital for future investments (Gilson, 2003). A mandatory distribution provision ensures that any profits gained from the liquidation of assets are immediately distributed, reducing the risk of such profits being mishandled by GP fund managers.

However, mandatory distribution provisions alone may not sufficiently protect LP investor interest, because they do not entirely remove the risk that GP fund managers will act in their own interest instead of that of the investor. A fund manager who is wary of a mandatory distribution obligation may instead choose to delay the IPO of a portfolio company in order to keep earning management fees. Again, this is more likely if a manager does not stand to earn significant carry fees and if management fees are a significant portion of the fund manager's remuneration (Harris, 2010). Furthermore, fund managers may delay their exit from investment to benefit their own interest of fundraising for future investments. Because of the information asymmetry discussed earlier, GP fund managers control much of the information about a fund's health and investments. Until these assets are brought to market, it

can be difficult to ascertain their exact value (Cumming, Gill, & Walz, 2009). By delaying their exit, managers can hide undesirable performance metrics or overvalue certain assets (Cumming et al., 2009). Such misreporting is particularly likely if the fund manager is under pressure to raise capital for a future fund (Cumming et al., 2009).

4.3. Duration/Liquidation Provisions

As mentioned above, limited partnerships often represent an ideal entity for PE/VC funds because the partnership agreement permits LP investors to specify how long their capital will remain “locked up” in the illiquid assets of the fund. By mandating that GP fund managers shut down the fund after a set period of time, investors can protect their interests and reduce agency costs (Gilson, 2003). Limiting the fund’s duration prevents a fund manager from becoming entrenched. If such a manager hopes for a continued career managing PE/VC funds, then he or she needs to perform well during the lifespan of the current fund to better attract prospective investors for future funds (Milhaupt, 1997). Mandatory liquidation also ensures that GP fund managers cannot automatically assume that current LP investors will opt to reinvest the profits gained, and the best way to invite reinvestment is to deliver good returns on their present investment and avoid misconduct (Gilson & Black, 1998). Furthermore, because PE/VC funds usually opt for a 10-year lifespan in their partnership agreements (Cheffins & Armour, 2008), a fund manager’s performance over this duration is a yardstick by which he or she can be compared to managers of other funds. This makes it easier for current investors to gauge the success of their manager and for investors at large to decide whether to shift their resources from one fund to another (Harris, 2010). Fund managers are thus encouraged to perform well, because their reputation may be at stake not just among current investors, but also those outside.

However, imposing a fixed lifespan on a PE/VC fund may also bring about undesirable behaviour from GP fund managers. For example, a fund manager might be less inclined to spend time managing a fund that is close to the end of its lifespan, because they may think that the fund’s outcome is already effectively cast in stone and look into future prospects (Gilson, 2003). He or she may choose instead to devote time to fundraising for future funds, or hand the current fund off to less experienced members of the same PE/VC firm to manage, thereby neglecting the interests of current investors. In fact, fund managers with a second, newer fund may choose to focus their energies there, and may direct the more promising investment opportunities towards the new fund (Harris, 2010).

Alternatively, the limited lifespan of a PE/VC fund could encourage fund managers to take excessive risks near the end of the fund’s life through a pressing need to meet the performance metrics set by investors. This has the potential to turn what might already be a bad situation into an even worse one if the manager acts recklessly. For example, the GP fund manager might deliberately gamble with acquiring risky companies in the hope of a windfall, the idea being that the success of such a high-profile investment may yet rescue the manager’s reputation in the eyes of LP investors (Gilson & Black, 1998). In such situations, it is possible that the fund manager’s investment decisions may not match investor preferences, because the manager may take on more risk than he or she ordinarily would (if this was their own money at stake) and more than his or her investors would want (Harris, 2010).

Designing a limited-duration partnership-type PE/VC fund may therefore actually jeopardise investor interest by encouraging negligent or downright risky behaviour. Such risks must be mitigated by combining duration/liquidation provisions with other layers of protection, such as the aforementioned idea of clearly specifying GP fund manager obligations and OB markers in the partnership agreement.

4.4. Incentivisation via a Remuneration Arrangement

The remuneration of GP fund managers can be structured in a partnership agreement to better align the interests of managers with that of investors. A common arrangement, known as the “two and twenty” (Fleischer, 2008), comprises two parts: firstly, a management fee that usually comprises 2% of the capital raised (Bankman & Cole, 2001); and secondly, a percentage of the fund’s profits paid to the managers (carry fee), usually 20% (Cosenza, 2005). By adjusting the source of a GP fund manager’s compensation, his or her interests can be brought in line with that of LP investors, better protecting investor interests.

The management fee component can sometimes make up nearly half of a fund manager's total compensation (Litvak, 2009). This is significant, because management fees may not be particularly effective at incentivising fund managers. Given that these fees are usually calculated based on a percentage of total capital raised, GP fund managers may focus more on the size of the fund than on its actual performance, and may spend more time trying to attract new investors rather than paying attention to current investments (Harris, 2010). In contrast, carry fees present an excellent way to align the interests of GP fund managers and LP investors, because both will profit from good investment (Gilson, 2003). The interests of investors in partnership-type PE/VC funds can therefore be better protected if the partnership agreement specifies that a significant portion of the fund manager's compensation will be derived from carry fees rather than management fees.

Furthermore, the protection of LP investor interests can be reinforced by including a clawback provision in the partnership agreement. If a fund does not meet specified investment targets, a clawback provision operates to recover any carry fees received by GP fund managers from successful earlier investments (Gilson, 2003). In this way, a fund manager cannot rest on the laurels of early successes, but must perform consistently for the entire lifespan of a given fund. To reinforce this, the clawback period should extend beyond the lifespan of the fund as fixed in the partnership agreement, so that recovery is always possible even in the event of a disastrous investment outcome at the eleventh hour. However, clawback provisions are not foolproof. Fund managers may have already squandered carry fees they received earlier, or the fees may be "locked up" in assets that cannot be readily liquidated to meet a call for their return (Harris, 2010). To remedy such situations, investors can specify in the partnership agreement that fund managers must maintain an escrow account with a portion of any carry fees received for the purpose of covering any potential clawback liabilities (Lin, 2013).

4.5. Encouraging Ownership

Giving GP fund managers a greater stake in the investment outcome will also help to protect the interests of LP investors. This can be achieved by requiring fund managers to contribute a small portion of the fund's capital, commonly 1% (Klausner & Litvak, 2001). Although this may seem like a token amount, the vast size of many PE/VC funds ensures that even 1% can represent a significant sum. In making this contribution, GP fund managers can be deterred from making reckless decisions that could harm their own personal financial investment (Harris, 2010).

However, precisely because a 1% contribution can still be a significant sum, forcing GP fund managers to cough up the capital can actually have detrimental effects. Investors in PE/VC funds tend to be large, sophisticated entities with diversified portfolios that include a variety of investments (Carey & Morris, 2010). Although the fund manager may be wealthy, it is unlikely that his or her resources are comparable. By forcing this manager to tie up his or her own resources in the PE/VC fund, they might be excessively cautious to avoid sinking their personal portfolio (Anabtawi, 2006). This could lead to suboptimal decision making on the part of fund managers.

An alternative could be to give GP fund managers co-investment rights relating to the PE/VC fund's investments. Rather than a mandatory contribution, fund managers would be allowed to co-invest their own resources together with the capital contributed by the LPs of the PE/VC fund, bringing their interests more in line with those of the LP investors (Greenberger, 2007). However, co-investment rights risk triggering conflicts of interest, because GP fund managers may dedicate a disproportionate amount of time to portfolio companies in which they have co-invested and thus have a personal stake, instead of dividing their attention adequately among all portfolio companies held by the fund (Lin, 2013).

4.6. Reputational Checks & Implicit Understandings

It has been argued that reputational sanctions play a key role in protecting investor interests by deterring errant behaviour on the part of GP fund managers in PE/VC funds (Rosenberg, 2002). Often, the main asset of a fund

manager is his or her track record (Cumming et al., 2009), so reputational sanctions can greatly damage the manager's chances of securing capital for future funds. A bad reputation is not merely an ethical issue, but also a matter of significant economic interest to the GP (Harris, 2010). This is a manifestation of market forces at their most basic level: the market will naturally calibrate itself so that investors will gravitate towards good fund managers, whereas bad managers will be avoided. These reputational controls shade into the concept of "implicit" understandings between LP investors and GP fund managers (Rosenberg, 2003). Of particular note is the general understanding that investors will only return to managers of good repute, which can deter GP fund managers from acting against the interests of their LP investors (Rosenberg, 2002).

4.7. A Unified Decision-Making Body

China offers a rather unusual method of protecting investor interest in partnership-type PE/VC funds. In China, it is not unusual for LPs to participate in decision-making, and some even have de facto control of the fund (Lin, 2013). In such funds, operational control is vested with an investment strategy committee, which includes both LPs and GPs, giving LPs far more latitude in protecting their own interests (Lin, 2013). However, while it may seem intuitive at first sight to conclude that giving LPs more power will better protect their interests, the opposite may be true. As mentioned above, it cannot be presumed that LP investors are better at managing a PE/VC fund (Davies, 2010), given, for example, that GP fund managers are supposed to be specialists in selecting and growing portfolio companies. If LP investors participate in decision-making, they may put the fund in a gridlock if their decisions conflict with those of GPs – or worse, the fund may perform suboptimally or incur losses.

More fundamentally, depending on the jurisdiction, a unified decision-making body incorporating both GPs and LPs may not be possible because local laws may forbid LPs from participating in the day-to-day operations of the PE/VC fund. This generally tends to be the case in most countries (Harris, 2010).

4.8. Statutory Intervention

Of course, much of the debate over protecting investor interests in partnership-type PE/VC funds would be obviated if a country explicitly legislated for such protection. In fact, countries need not import common law fiduciary duties in their entirety to achieve a measure of protection for investors. It has been recognised that simply increasing the disclosure obligations of GPs helps (Kraakman et al., 2009). Greater disclosure of information such as the valuations of portfolio companies or their annual financial reports could significantly reduce agency costs by preserving investor interests (Lin, 2013).

Alternatively, a country can better protect investors by strengthening their recourse to derivative action mechanisms. Some jurisdictions with major PE/VC markets, such as the US, recognise that LPs have a right to bring a derivative action in the name of the partnership if GPs with the authority to do so have refused or are unlikely to do so (as is commonly the case if the GPs themselves are at fault) (Hecker, 1980). For jurisdictions such as China, where the regulatory framework, requirements and procedures pertaining to derivative action are unclear (Lin, 2013), strengthening the derivative action mechanism could really encourage LP investors to launch such actions against errant GPs to protect their interests.

Conclusions

Taking a step back, there is actually a wide variety of tools that can be used to protect investor interests in partnership-type PE/VC funds, as elucidated above. None are perfect, but if used in tandem, are likely to achieve some effect. However, many of these tools are contractual in nature and rely on intelligent crafting of the partnership agreement, as well as significant bargaining power on the part of LP investors when negotiating an agreement. The investor is often the party best positioned to protect his or her own interests, and should plan accordingly even before a PE/VC fund is formed. This still presents a problem for less sophisticated individual investors, who may not be as aware of all the tools available, and are therefore less able to protect themselves. It must always be borne in mind that contractual protection only works where it has specifically been contracted for, whereas blanket

fiduciary duties automatically apply to rescue even the most ignorant of investors. This is a fundamental difference, and an inherent problem with protection arising from contracts.

This paper has described the nature of fiduciary duties in a PE/VC context, with examples from specific countries. Moving forward, a more comprehensive survey of jurisdictions, particularly those with nascent PE/VC industries, may reveal novel regulatory regimes that could inform future solutions. Studies that correlate the presence or absence of particular fiduciary duties with the growth or stability of local PE/VC industries may also provide a more quantitative approach to analysis.

At the end of the day, GP-LP relations in partnership-type PE/VC funds will always be at least partially a matter of trust, because such funds involve the coming together of different people with different roles, resources and interests. And like any other scenario in which two parties must meet in the middle, there is no foolproof way to ensure that one side (in this case, the investors) is always protected. Although the various solutions discussed above can mitigate the risk, finesse and caution should always be exercised by investors when entering into partnership-type PE/VC funds.

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